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U.S. BUSINESS OUTLOOK SHORT-TERM

With consumers firmly in the saddle, the economy galloped ahead at breakneck speed in 1983's second quarter. Total consumer spending after inflation surged nearly 10% at an annual rate. Consumer purchases of durable goods like cars and furniture shot up at a 32% annual rate.

Most other sectors of the economy also contributed to economic growth. New housing construction continued to boom. Military outlays rose. Companies did less inventory cutting than earlier in the year, which meant more production. And for the first time in nearly two years, business capital spending increased.

The biggest bad news in the second quarter was the U.S. international trade position, which at this point looks hopeless. Overwhelming good news from other sectors, however, produced rapid economic growth of 9.2% at an annual rate in the April to June period. In the current quarter, continued good news is forecast to spur vigorous growth of 6+%.

It's impossible, of course, for the economy to sustain this kind of advance for any length of time. But it is possible for the recovery to roll forward at a 3%-5% annual clip through next year. To turn that possibility into reality in part requires continued consumer spending, though not at the torrid second-quarter rate. More important at this stage of the business cycle, it requires a capital investment mini-boom

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and some inventory rebuilding. Under current circumstances these goodies are probably attainable...at least in the short run. But to get past, say, the next six months requires that interest rates behave themselves and not cause a ruckus by shooting much beyond where they are now.

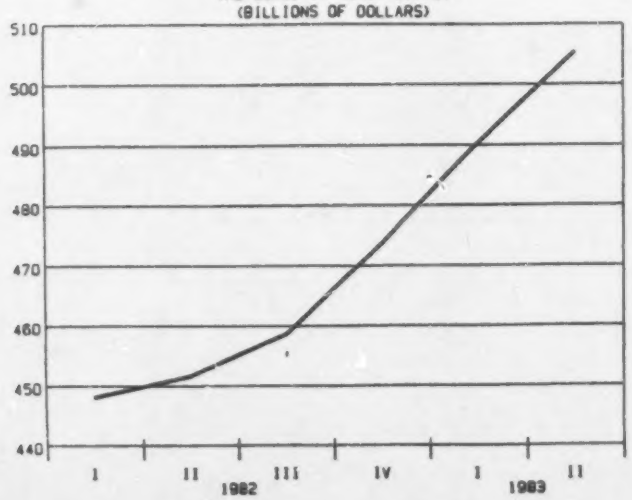
An Interest-Rate Respite, But For How Long?

The prospect for interest rates behaving in the near term is good. To the extent that rates are influenced by inflation, the pressure has eased considerably. The broadest measure of inflation--the gross national product (GNP) deflator--rose at only a 3.5% annual rate in the second quarter. For 1983 as a whole it is forecast to rise 4.4%, down from 6% last year and 9.4% in 1981.

To the extent that expected inflation affects current rates, however, pressure could be building. Investors, for example, may be convinced that inflation--hence interest rates--will spurt due to the money supply's rapid growth since the summer of 1982. (See Figure I.) Money growth, however, tends to affect prices with a long lag.

FIGURE I

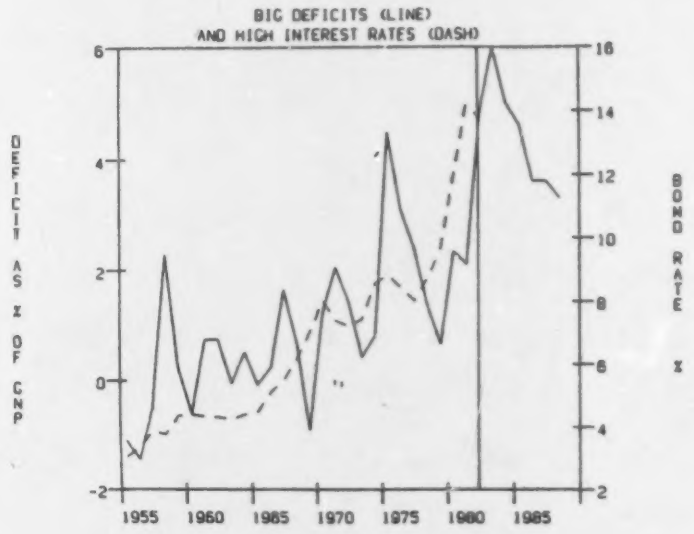
THE SURGE IN MONEY SUPPLY
(BILLIONS OF DOLLARS)



In the meantime, lots of spare industrial capacity plus scaled-down labor cost increases should keep prices under wraps into 1984.

But while the Scylla of inflation may be contained for awhile, the Charybdis of massive federal deficits seems uncontrollable. These $200 billion budget deficits are massive not only in absolute terms but also as a share of GNP. And even using optimistic assumptions, the deficits will remain massive in the next several years, as shown in Figure II. (Projected deficits as a share of GNP are from the Congressional Budget Office.)

FIGURE II



Also shown in Figure II are long-term interest rates, which have trended up over time along with federal deficits. Those who think interest rates will decline like to point out the lack of direct relationship between large deficits and high interest rates. But looking at interest rates and budget deficits in any one time period doesn't make much sense--especially when that time period is the early stage of an economic expansion.

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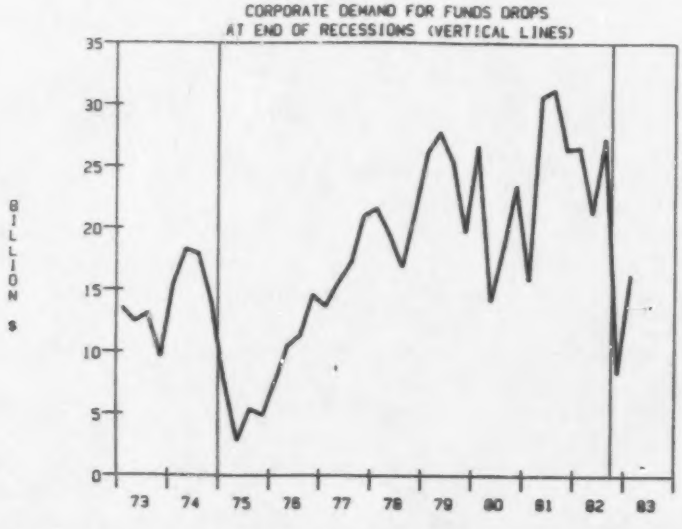
For early in an expansion budget deficits are usually large as the government tries to spend its way out of trouble and as tax receipts trickle down due to the weak economy. At the same time, capital outlays get cut and inventories get reduced while profits pick up, so companies don't have to borrow much money; and the Federal Reserve Board is often trying to do its part for recovery by revving up the money supply. With money supply up and demand for funds down, it's no surprise that interest rates fall even as budget deficits grow.

Once the expansion gets going, however, the story changes. Firms want to upgrade plant and equipment and to rebuild depleted stocks of materials and goods. Corporate cash flow continues to improve, but cash needs escalate faster, fostering demand for external funds. This pattern is illustrated by Figure III, which shows quarterly debt raised by nonresidential corporations.

FIGURE III



As the figure also shows, the economy is now at the stage where demand for funds begins to rise. Demand is starting from a very low

level, however, so for some period of time the U.S. Treasury should be able to raise record amounts without crowding out private borrowers and/or driving interest rates up too much.

Unfortunately, this period of relative interest rate calm may not last long. The forecast assumes it will last at least through the end of this year. (Besides sluggish demand for external funds, rates could even fall due to efforts by the Fed to offset the second-quarter interest rate rise.) Later on, however, as the private sector seeks more funds for plant, equipment, and inventories, and as the government continues to fund its deficits, interest rates will rise. The assumption here is that rates make a persistant move up by mid-1984.

A major issue in the outlook, therefore, is how strong the capital spending and inventory recovery--hence overall recovery--will be in the face of this interest-rate constraint.

Capital Goods Get Going...

At the moment, capital expenditures are beginning to stage a rally. Adjusted for inflation, they spurted 6.1% at an annual rate in 1983's second quarter--the first advance since 1981's third quarter. All of the action, however, has been in equipment. Structures--especially factories and office buildings--are still slumping, and are expected to continue to slump.

Within equipment, moreover, much of the action has been in high-tech equipment like computers and in cars and trucks. Investment in heavy industrial and other types of equipment, however, has also started to pick up, as shown in Chart I.

Chart I. Business Starts to Boost Equipment Investment

Type of Capital Equipment Purchased	Billions of 1972$ (SAAR) 1982 II	1982 III	1982 IV	1983 I	1983 II	% Change, 1982:II to 1983:II
High-Tech	$51.6	$51.8	$51.5	$52.9	$54.7	6.0%
Industrial	17.4	16.4	15.0	15.1	15.6	-10.3
Autos & Trucks	16.5	16.0	15.7	16.7	17.5	6.1
All Other	27.7	26.1	26.1	24.9	26.0	-6.1
TOTAL	113.1	110.3	108.3	109.6	113.9	0.7

NOTE: High-Tech equipment includes computers, other office and store equipment, communication equipment, and engineering and photographic instruments.

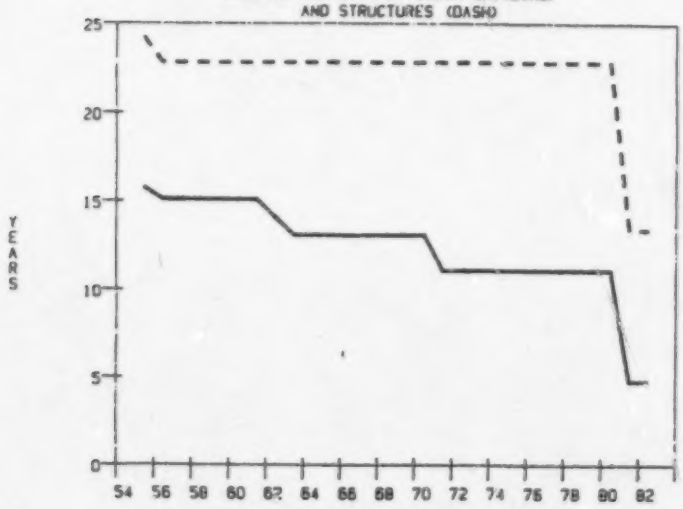
SAAR - Seasonally Adjusted Annual Rate

Despite high interest rates, total equipment purchases are forecast to continue to rise at a healthy clip through the end of next year. Key reasons: 1) Firms will want to modernize equipment to cut production costs, since easy profits can no longer be gotten simply by raising prices. 2) Equipment will be financed extensively by internal funds. 3) Internal funds will grow as the recovery continues, and as firms take advantage of the pro-investment tax laws. Figure IV illustrates the law's dramatic cut in tax lives that will increase depreciation charges, reduce taxes, and hike business cash flow.

In the two years since the 1981 Tax Act was enacted, deep recession thwarted capital spending more than tax benefits boosted it. Now, in contrast, economic growth is providing incentives to invest in equipment, so that tax benefits (even as reduced by the 1982 Tax Act) will flow to corporations and thus keep equipment purchases up.

FIGURE IV

AVERAGE TAX LIFE OF EQUIPMENT (LINE)
AND STRUCTURES (DASH)



But Construction and Autos Start Slowing

The recovery and the tax law will not, however, immediately boost investment in structures. Office construction, in particular, could plunge due to the large overhang of available space on the market. Similarly, because plenty of industrial capacity is sitting idle, manufacturers will likely continue to cut back factory outlays, now running 30% below a year ago.

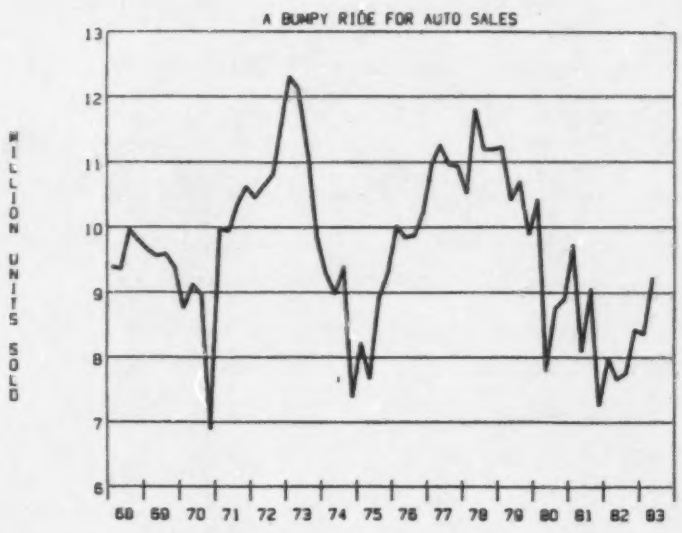
By contrast, other areas of private nonresidential will be increasing. Building of stores, for example, should begin to respond to the burst in new home construction that began nearly a year ago.

New home construction itself, however, has probably topped out. Given the recent rise in mortgage rates and the likelihood that mortage rates will remain above 13%, housing starts are forecast to dwindle as a power source for the recovery. Especially next year, when business and government are competing for funds, homebuyers will probably come out

the losers. Hence after enjoying a 50%-60% surge in 1983, housing starts are expected to drop a bit in 1984.

Besides housing dropping out as a major force behind the economic expansion, consumer spending will probably also power down. For just as housing usually leads a recovery in response to declining interest rates and rising confidence, so too does consumer spending on autos. An auto boom, though, must eventually run out of gas. Typically the rapid acceleration phase lasts a year or so, which in the present case would date from last fall. (See Figure V.) Add the fact that current

FIGURE V



interest and unemployment rates are atypically high, and it seems that auto purchases will begin to falter, though not fall.

If auto purchases shift into lower gear, overall gains in consumer spending will slow down. Nonetheless, because people's after-tax income just got a boost from the July 1 tax cut, because rising employment will further boost income, and because households are not overburdened by debt, consumer spending is expected to keep on trucking at a 2.5%-4.5%

annual pace in each of the next six quarters. That's far lower than the second quarter's 10% surge, but it's enough to keep the recovery alive.

The Recovery Requires an Inventory Injection

But just staying alive is not good enough at this early stage of recovery. The hope rather is that the recovery will retain some vigor. Yet with housing and nonresidential construction weakening and with auto sales slowing, the economic tonic must flow from other sources.

Capital equipment purchases, as already argued, should be one of those sources. Another key element must be business inventories.

Chart II compares business' management of inventories during the 1981-82 and 1973-75 recessions. The outstanding point here is that in

Chart II. Business Cut Inventories Quickly in Recent Recession

Change in Business Inventories
Billion 1972$ (SAAR)

	1974-75 Recession (Dates at Left)	1981-82 Recession (Dates at Right)	
1974 I	13.2	16.1	1981 III
II	12.6	6.0	IV
III	7.7	-10.2	1982 I
IV	12.9	-3.4	II
1975 I	-14.3	-1.3	III
		-22.7	IV
II	-11.3*	-15.4	1983 I*
III	1.0*	-4.5	II*
IV	-2.3*		

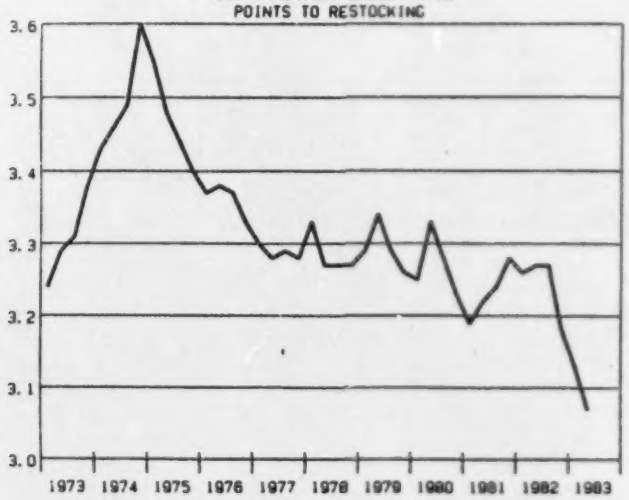
*Recovery.
SAAR - Seasonally Adjusted Annual Rate

the recent recession companies slashed inventories nearly all the way through, while it wasn't until the very end of the mid-70s recession

that inventories got cut. Hence the present ratio of inventories to sales is far lower. Figure VI shows how low this ratio is compared not only to 1975, but compared to the past ten years in general.

FIGURE VI

LOW INVENTORY-SALES RATIO
POINTS TO RESTOCKING



With inventories under much better control this time around, they should grow faster than in the 1975 expansion. Unfortunately, however, there is one offset--interest rates now are far higher than in 1975. So even with sales on the upswing, cost-conscious managers may try to keep inventories as tight as possible to keep interest payments as low as possible. With sales continuing to climb, though, shelves and warehouses will have to be restocked to some extent to meet increased demand. Therefore, inventory building should soon provide some oomph to the current recovery.

Inventories are also projected to grow next year, so that for 1984 as a whole the change in business inventories will play a major role in sustaining economic growth. The importance of inventories in strengthening the recovery is illustrated in Chart III, which shows the forecast in inflation-adjusted terms.

Chart III. Inventories & Equipment Take Leading Roles

	Real % Change		
	1982	1983	1984
GNP	-1.9%	-3.0%	4.5%
Consumer Spending	1.4	4.2	3.6
Nonresidential Fixed Investment	-4.8	-1.7	5.7
Producers' Durable Equipment	-7.5	1.7	8.0
Structures	1.7	-9.0	0.0
Residential Investment	-15.4	35.2	4.1
Inventory Change (Billion $72)	-9.4	-2.1	17.0
Net Exports (Billion $72)	28.9	11.1	3.3
Government Spending	1.8	1.3	4.2

In sharp contrast to inventories, net exports--now getting bushwacked by the strong dollar and weak foreign markets--are forecast to remain under the gun in 1984. The culprits next year will remain the same--a dollar kept strong by high interest rates and foreign markets recovering more slowly than the U.S.

Government spending, meanwhile, is expected to pick up in 1984 because of increased tax revenues and political pressure to raise federal nondefense expenditures. The most quickly advancing flank of government spending will, of course, continue to be the military.

Summary

The forecast calls for recovery to continue through the end of next year, with investment in capital equipment and in inventories as the key movers. Continued gains in consumer spending, driven by increasing incomes, also play a central role.

Consumer spending is not, however, expected to sustain its super-strength of the second quarter because auto sales are likely to slow down. New home building should also taper off in response to 13+% mortgage rates.

Crucial to this scenario is the assumption that interest rates do not spurt much before mid-1984. Which is reasonable, given that early in recovery business' demand for external funds is usually small due to rising cash flow and limited investment plans.

Once the recovery gets rolling, however, business' need for funds will grow. The U.S. government's concurrent need to plug record deficits could then steer the economy onto a crash course. Thus interest rates are expected to rise in 1984. Yet private sector demand for funds is expected to be modest enough to prevent a sharp spike in rates.

Even as financial red flags go up next year, however, continued economic growth should encourage business to build inventories and replace and modernize capital equipment. If, on the contrary, business and consumers rein in spending as soon as they see interest rates head upward in earnest, the recovery could suffer a premature demise.

If the reaction to higher interest rates is delayed, as assumed, the threat to economic growth won't assert itself until 1985. Unless, of course, politicians in an election year defuse the threat by making some progress on the deficit. Without putting much faith in a political cure, the forecast nonetheless puts economic growth at 3% this year followed by 4.5% in 1984.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS

(Billions of Dollars, SAAR)

	-Actual-	----------Forecast----------						--------Annual--------		
	1983	1983		1984						
National Product Accounts	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1982	1983	1984
Gross National Product	3270.0	3353	3423	3484	3550	3640	3734	3073.0	3304.4	3602.0
Consumer Spending	2148.4	2193	2238	2279	2324	2373	2423	1991.9	2163.1	2349.8
Durables	278.0	285	291	295	299	302	304	244.5	278.1	300.0
Nondurables	798.2	810	825	839	855	874	894	761.0	802.6	865.5
Services	1072.2	1098	1122	1145	1170	1197	1225	986.4	1082.4	1184.3
Fixed Investment	463.7	473	481	488	499	512	522	439.1	465.3	505.3
Nonresidential	335.9	340	349	355	364	376	386	348.3	339.3	370.3
Structures	127.4	126	127	127	129	134	139	141.9	128.3	132.3
Producers Durable Equipment	208.5	214	222	228	235	242	247	206.4	211.0	238.0
Residential	127.7	133	132	133	135	136	136	90.8	126.0	135.0
Inventory Change	-11.9	5	9	13	18	28	35	-24.5	-9.3	23.0
Government Purchases	682.1	701	723	736	745	765	792	649.2	695.9	759.5
Federal	272.7	284	298	301	301	311	327	258.7	282.0	310.0
Defense	199.9	204	211	213	219	226	235	179.4	202.3	223.3
Nondefense	72.8	80	87	88	82	85	92	79.3	79.7	86.8
State & Local	409.4	417	425	435	444	454	465	390.5	413.9	449.5
Net Exports	-12.3	-19	-28	-32	-36	-38	-38	17.4	-10.6	-36.0
Real GNP (1972 Dollars)	1523.4	1546.9	1559.6	1575.3	1587.6	1606.7	1624.0	1485.4	1530.0	1598.4
(% change at annual rate)	9.2	6.3	3.3	4.1	3.2	4.9	4.4	-1.9	3.0	4.5
Implicit Price Deflator	214.65	216.76	219.48	221.16	223.61	226.55	229.93	206.88	215.97	225.35
(% change at annual rate)	3.5	4.0	5.1	3.1	4.5	5.4	6.1	6.0	4.4	4.3
Key Economic Indicators & Assumptions										
Unemployment Rate (%)	10.0	9.4	9.1	8.8	8.6	8.4	8.2	9.6	9.7	8.5
Housing Starts (thousands of units)	1688	1650	1600	1625	1625	1600	1575	1059	1658	1606
Consumer Price Index	4.2	4.6	4.3	4.7	4.5	4.5	4.5	6.2	3.2	4.5
(% change at annual rate)	8.4	9.1	9.0	9.3	9.8	10.5	11.0	10.6	8.7	10.2
90-Day Treasury Bill Rate (%)	11.6	12.1	12.0	12.0	12.5	13.0	13.5	13.8	11.9	12.8
Corporate Bond Yield (%)	2715.7	2776	2843	2913	2981	3049	3118	2578.6	2748	3015
Personal Income ($ Billions, SAAR)	2030.0	2374	2428	2484	2539	2593	2648	2176.5	2340	2566
Disposable Personal Income ($ Billions, SAAR)	4.0	5.3	5.8	6.0	6.0	6.0	6.0	5.8	5.1	6.0
Saving as % of Disposable Income										

SAAR-Seasonally Adjusted Annual Rate